



**American Insurance Association**

2101 L Street, NW  
Suite 400  
Washington, DC 20037  
202-828-7100  
Fax 202-293-1219  
[www.aiadc.org](http://www.aiadc.org)

April 30, 2013

**BY ELECTRONIC MAIL**

Board of Governors of the  
Federal Reserve System  
Attn: Robert deV. Frierson, Secretary  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551  
[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)

**Re: Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies (FRB Docket No. R-1438; RIN 7100-AD86)**

Ladies and Gentlemen:

The American Insurance Association (“AIA”) appreciates the opportunity to provide comments on the Board of Governors of the Federal Reserve System’s (“Board”) proposed rule regarding enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies (“Proposed Rule”).<sup>1</sup> AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to U.S. consumers and businesses. AIA members write more than \$117 billion annually in U.S. property-casualty premiums and approximately \$225 billion annually in worldwide property-casualty premiums. Our members are keenly interested in the Proposed Rule because we believe it is critical that the Board develop prudential standards applicable to foreign banking organizations and designated foreign nonbank financial institutions that are appropriate for such companies that may have affiliates that are property-casualty insurance companies.

**SUMMARY**

AIA recognizes the Board’s responsibilities under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) extend to U.S. operations of foreign banking organizations and foreign nonbank financial companies subject to Board supervision. However, as we have pointed out on several occasions, the Dodd-Frank Act recognizes that the business of insurance differs significantly from

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<sup>1</sup> 77 Fed. Reg. 76628 (December 28, 2012); 78 Fed. Reg. 13294 (February 27, 2013).

banking, and it is critically important for the Board's actions to implement the plain statutory language providing that insurers subject to regulation under section 165 will be subject to insurance-based, not banking-based, standards and requirements.

AIA believes that the Proposed Rule provision that may require companies to establish U.S. intermediate holding companies may have unintended consequences, such as imposing an increased tax burden, on companies. To minimize potentially adverse effects, AIA recommends that the Board not require foreign nonbank financial companies to include within the holding company structure companies, such as insurers, that do not present a substantial risk to the U.S. financial system and which are regulated and supervised under state or federal law.

AIA also believes that the Proposed Rule does not adequately consider the myriad organizational governance structures and relationships that are reflected among those engaged in the business of insurance. Accordingly, we believe that the Board's final rule should explicitly carve out from the definition of "control" certain structures, examples of which are provided below, that reflect the unique organizational structure of the insurance industry.

## **BACKGROUND**

The Board states that it is responsible for the overall supervision and regulation of the U.S. operations of foreign banking organizations. Currently, the Board does not impose capital standards on U.S. bank holding companies that are subsidiaries of foreign banking organizations. Accordingly, foreign banking organizations currently are not required to maintain capital against the consolidated assets resulting from their U.S. operations, which include the assets of their U.S. subsidiaries. However, in view of several considerations, including enactment of the Dodd-Frank Act, the Board proposes to establish enhanced prudential standards for U.S. bank holding company subsidiaries of foreign banking organizations with total consolidated assets of \$50 billion or more and U.S. subsidiaries of designated foreign nonbank financial companies. The proposed prudential standards include risk-based capital and leverage requirements, liquidity standards, risk management and risk committee requirements, single counterparty credit limits, stress test requirements, and a debt-to-equity limit.

The Board recognizes that other federal and state regulators are primarily responsible for supervising and regulating certain parts of the U.S. operations of foreign banking organizations. The Board acknowledges that state insurance authorities are the primary supervisory and regulatory agencies with regard to insurance companies that are part of foreign banking organizations. Moreover, the Board states that it possesses authority to tailor the application of the standards it proposes to adopt on an individual company basis or by category.<sup>2</sup> However, it would be inconsistent with those provisions of the Dodd-Frank Act that recognize, as the Board does, the importance of preserving the current structure of state regulation of insurance for the Board to base regulation of insurers under section 165 on the banking standards set forth in the Proposed Rule, rather than on existing insurance regulation.

The proposal also recognizes that not all foreign banking organizations that meet the statutory asset size thresholds, particularly those with a small U.S. presence, present the same level of risk to U.S. financial stability. As a result, the proposal would apply a reduced set of requirements to foreign banking

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<sup>2</sup> 77 Fed. Reg. at 76631. 12 U.S.C. § 5365(b)(3) .

organizations with combined U.S. assets of less than \$50 billion in light of the reduced risk these companies pose to U.S. financial stability.

As AIA has consistently indicated in previous submissions to the Board and the other Federal financial institution regulatory agencies, the Dodd-Frank Act differentiates in numerous places between insurance companies and banking organizations. These distinctions must be reflected in regulations that are adopted in accordance with the Act. This is of particular importance in instances in which the Proposed Rule may impose standards that apply bank-centric standards to entities such as property-casualty insurers that are controlled by foreign banking organizations or nonbank financial companies. For example, in AIA's February 2011 comments to the Agencies on the joint notice of proposed rulemaking with respect to Basel II capital adequacy standards, AIA urged the Agencies to distinguish property-casualty insurance companies based on their unique business model and accompanying state-based financial regulatory system, noting that "it is critical that the Agencies employ risk-based capital standards that are suitable and reflective of the risks that are inherent to property-casualty insurers."<sup>3</sup>

In our April 30, 2012 comment to the Board on proposed Regulation YY, "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies," AIA advised that the property-casualty insurance industry has not been a source of instability to the U.S. financial system or U.S. economy and, as a result, it is highly unlikely that property-casualty insurers would be designated as systemically important.<sup>4</sup> Nonetheless, it is possible that a U.S. property-casualty insurer could be part of a foreign banking organization with a U.S. presence or nonbank financial company subject to Board supervision. Accordingly, AIA urges that, in its final rule, the Board adhere to Dodd-Frank's intent to respect the insurance industry business model and defer to the existing state-based system of regulation. AIA believes that the Board should rely upon existing insurance industry metrics, terminology and concepts, such as capital and leverage measurements established by state insurance authorities, financial surveillance, and annual state filings, as well as risk management tools such as the Own Risk Solvency Assessment (ORSA). These measures have been developed expressly for the insurance industry and reflect the appropriate manner in which insurers should be evaluated.

#### I. Scope of Foreign Nonbank Financial Company in Proposed Rule

AIA is mindful of the term "foreign nonbank financial company supervised by the Board," as it is used throughout the Proposed Rule. Section 113 of the Dodd-Frank Act was careful to limit its considerations with respect to foreign nonbank financial companies to the U.S. operations and importance as a source of credit to U.S. consumers and businesses and as a source of liquidity to the U.S. financial system. When the Financial Stability Oversight Council ("Council") proposed its rule implementing this section of the Dodd-Frank Act, it further emphasized the U.S. focus of its inquiry with respect to foreign nonbank financial companies by acknowledging that "the same categories and framework would be used in the case of a foreign nonbank financial company, although the statutory factors included as part of this analysis would be adjusted to reflect the focus of certain of those factors on the U.S. operations of the

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<sup>3</sup>Comments of the American Insurance Association in Response to "Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Establishment of a Risk-Based Capital Floor (OCC Docket ID OCC-2010-0009; FRB Docket No. R-1402 and RIN No. 7100-AD62; FDIC RIN 3064-AD58 and PIN XXXX-XXXX)," at p. 2 (Feb. 28, 2011).

<sup>4</sup>Comments of the American Insurance Association in Response to "Proposed Regulation YY - Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (RIN 7100-AD-86; Docket No. 1438)," at p. 1 (Apr. 30, 2012).

foreign nonbank financial company.”<sup>5</sup> This was further reflected in the final rule by using a stage 1 consolidated asset calculation that is based on “global total consolidated assets” for U.S. nonbank financial companies, as opposed to “U.S. total consolidated assets” for foreign nonbank financial companies.<sup>6</sup> AIA assumes, for purposes of responding to the request for public comment, that the Board does not intend to interfere with the operation of the FSOC designation rule nor alter the scope of foreign nonbank financial companies supervised by the Board.

## II. Intermediate Holding Company Requirement

The Board proposes to require certain foreign banking organizations to form a U.S. intermediate holding company to serve as a U.S. top-tier holding company for the company’s U.S. subsidiaries. While the Board is not proposing to require every foreign nonbank financial company supervised by the Board to form a U.S. intermediate holding company, the proposal sets forth criteria the Board would consider to determine whether a U.S. intermediate holding company should be established by such a foreign nonbank financial company, and seeks public input on the appropriateness of the formation of such an entity. The criteria include such factors as (a) the structure and organization of U.S. activities and subsidiaries; (b) riskiness, complexity, financial activities and size of U.S. activities and subsidiaries, including their interconnectedness with foreign activities and subsidiaries of the company; (c) the extent to which the foreign company is subject to prudential standards on a consolidated basis in its home country; and (d) any other risk-related factor that the Board determines appropriate.

AIA appreciates that the Board will assess on a case-by-case basis whether to require a foreign nonbank financial company to establish a U.S. intermediate holding company for its U.S. activities and subsidiaries. As discussed above, we believe that it is important for the Board to acknowledge that in making its determination, the Board will be cognizant of the factors taken into account by the Council in its designation process<sup>7</sup> and fashion its determination in a manner that is consistent with the procedure and standards applied by the Council. Accordingly, AIA believes it is important for the Board to proceed cautiously before requiring foreign nonbank financial companies to disrupt their organizational structure by requiring the establishment of a U.S. intermediate holding company. For example, requiring an intermediate holding company for currently disparate U.S. reporting groups can result in unintended tax federal and state tax consequences. The initial combination may not be eligible for a tax-free combination and ongoing state income tax costs may be particularly burdensome to the organization. The tax disparity may be more pronounced in organizations that include insurance subsidiaries that could be forced to consolidate with non-insurance companies at the state level. Accordingly, AIA believes that in applying its criteria, the Board should not require a foreign nonbank financial company to establish an intermediate holding company for its U.S. operations if the requirement would result in significant adverse effects, such as increased tax consequences, to the company.

If the Board determines to require a foreign nonbank financial company to establish a U.S. intermediate holding company, AIA recommends that the company should be permitted to exclude from the structure subsidiaries that are regulated and supervised at the federal or state level that do not present

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<sup>5</sup> Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 *Fed. Reg.* 4555, 4560 (January 26, 2011).

<sup>6</sup> Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 *Fed. Reg.* 21637, 21661 (April 11, 2012).

<sup>7</sup> *Id.*

a material threat to U.S. financial stability. We see little reason to require a foreign company to include a U.S. property-casualty insurer within its U.S. intermediate holding company structure when the insurer does not present any substantial risk to the U.S. financial system. Such an approach is consistent with the goals of the Dodd-Frank Act without interfering with the orderly operations of the company. Such an approach would also have the benefit of avoiding inconsistency with the regulatory accounting standards that apply to the insurance industry.

### III. Definition of Control

If a foreign nonbank financial company is required to form a U.S. intermediate holding company, it will be required to fold entities it controls into the intermediate holding company and file its reports to the Board on a consolidated basis. For purposes of the Proposed Rule, the Board proposes to use the definition of “control” set forth in section 2(a) of the Bank Holding Company Act (“BHCA”). AIA believes that using the BHCA definition of control is inappropriate for property-casualty insurers. For example, in instances where an insurance company (or its affiliate) is by contract performing advisory or similar type services for another company, but does not have any ownership interest in such company, under the BHCA, the insurer could be deemed to control the other company despite the fact that the insurer has no operational control over the other company. Nonetheless, applying the BHCA definition would require the insurer to consolidate all of the assets and other financials of the other company into its reports to the Board. Such a requirement would result in a distorted picture of the insurer’s financial condition.

Further, the insurance industry has spawned a variety of conventional and unconventional organizational structures, some of which may not fit squarely under the BHCA definition of control. Those structures include stock insurance companies, mutual insurance companies, fraternal benefit societies, cooperatives, special purpose vehicles, pools, Lloyds associations, risk retention groups, residual market mechanisms, and reciprocal insurance exchanges.<sup>8</sup> Some of these different organizational structures include sub-categories as well. For example, reciprocal insurance exchanges typically involve member-policyholders who insure each other, have member-controlled governing boards, and an attorney-in-fact that manages the operation, but is not the insurer or the owner of exchanges and has no liability for losses. For a reciprocal, the members are the “insurance company.”<sup>9</sup> Other organizational forms have different characteristics that determine who may possibly exercise a controlling influence. Accordingly, AIA recommends that in the context of the Proposed Rule, the Board should define “control” in a manner that takes into account the unique nature of the relationship between parties.

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<sup>8</sup> For definitions of a number of these structures, see A.M. Best, *Best’s Insurance Resources, Glossary of Insurance Terms*, available at <http://www.ambest.com/resource/glossary.html#A> and Insurance Information Institute, *Glossary of Insurance Terms*, available at <http://www2.iii.org/glossary/>.

<sup>9</sup> See Couch on Insurance, Third Edition, Lee Russ (in consultation with Thomas Segalla), §39:48. Definitions and Distinctions & §39:53. Legal Status (December 2012) (discussing reciprocal insurance exchanges generally and the role of the attorney-in-fact).



## **CONCLUSION**

AIA appreciates the opportunity to provide comments to the Board on its Proposed Rule. AIA believes it is important that the Proposed Rule be fashioned in a manner that takes into account that property-casualty insurers present virtually no systemic risk to the U.S. financial system. Such a rule would enable the industry to continue to effectively meet the needs of insurance consumers in the United States, and would allow the Board to concentrate its resources on those activities and entities within a foreign banking organization or foreign nonbank financial company that present such a risk.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'J. Stephen Zieleski', with a long horizontal flourish extending to the right.

J. Stephen ("Stef") Zieleski  
Senior Vice President & General Counsel  
American Insurance Association  
2101 L Street, N.W.  
Suite 400  
Washington, DC 20037  
202-828-7100